

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

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date: August 17, 2012

to:

(Large Business & International)

from:

(Office of the Associate Chief Counsel)  
(Corporate)

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subject: Bankruptcy Related Issues

Legend

Holdco =

Successor =

Sub 1 =

Sub 2 =

Business =

State A =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Year 1       =

Year 2       =

Year 3       =

a           =

b           =

c           =

d           =

e           =

f           =

g           =

This is a written response to your request for Chief Counsel Advice, dated April 6, 2012. This supersedes our prior advice dated July 16, 2012.

#### I.       Issues

1. Whether the taxpayer (Successor) must recognize cancellation of indebtedness income as a result of certain of its insurance subsidiaries participating in a stock for debt exchange in state insolvency proceedings?
2. Whether Successor is entitled to an additional deduction in Year 3 above the amount it previously treated as unpaid losses under § 832(b)(5) of the Internal Revenue Code?
3. Whether Successor is required to reduce its unpaid losses by the amount of unpaid losses allocable to losses paid during the year?
4. If Successor is required reduce its unpaid losses, does Successor have to recognize the adjustment as cancellation of indebtedness under § 108(e)(10)?
5. Whether Successor is entitled to a deduction for “interest” assigned to the Deficiency and Latent Deficiency Claims when the ultimate value of the paid losses pursuant to the stock for debt exchange is insufficient to “pay” an “interest” amount?

#### II.      Recommendation

1. Successor does not have to recognize cancellation of indebtedness income under § 108(e)(10) to the extent Sub 1 and Sub 2 were insolvent on the date of discharge of indebtedness.
2. With respect to the Latent Deficiency Claims determined in Year 3, Successor is not entitled to an additional deduction for unpaid losses of the amount above which it previously treated as unpaid losses.
3. Successor is required under § 832(b)(5) to reduce its unpaid losses by the amount of unpaid losses allocable to losses paid during the year. Successor should reduce its unpaid losses by the amount of unpaid losses allocable to the Deficiency and Latent Deficiency Claims paid during Year 3 because those claims were not outstanding at the end of Year 3, and those claims were paid in stock with a fair market value less than the amount of unpaid losses for such claims.
4. Although Successor is required to reduce its unpaid losses under § 832(b)(5) to reflect the payment of the of the Deficiency and Latent Deficiency Claims, under § 108(e)(10) as applicable to Successor, Successor does not have to recognize this reduction.
5. Successor is not entitled to a deduction for “interest” assigned to the Deficiency and Latent Deficiency Claims when the value of the stock used to satisfy such claims pursuant to the stock for debt exchange is insufficient to “pay” an “interest” amount.

### III. Facts

Holdco, a holding company, was engaged in Business through its subsidiaries, including Sub 1 and Sub 2.

In Year 1, Sub 1 and Sub 2 became insolvent and were placed in conservatorship under the control of the State A Commissioner. On Date 1, Holdco was forced into federal bankruptcy.

In coordination with Federal Bankruptcy Court proceedings and the State A Regulators, the Holdco group established a framework for the restructuring of insolvent Sub 1 and Sub 2: the Reorganization, Rehabilitation, and Restructuring Agreement (the “Agreement”). On Date 2, the Superior Court of State A approved the Final Order of Rehabilitation, and on Date 3, the Federal Bankruptcy Court confirmed a Joint Plan of Reorganization, including in both cases the Agreement.

Pursuant to the Agreement, Sub 1 and Sub 2 issued new common stock and transferred substantially all of their assets to newly created trusts, with the state receiver as trustee. The trustee was to pay all debts of each entity to the extent of available assets and satisfy the remaining claims with the newly issued stock. As part of the

Agreement, Holdco would issue new common stock to the trustee, which would be exchanged for the newly issued Sub 1 and Sub 2 common stock. Under the trust arrangement, any creditor of the insurance entities was deemed to have exchanged its claim for interests in Holdco common stock. On Date 4, Holdco issued stock to the Commissioner on behalf of holders of deficiency claims.

Claim holders, however, did not actually receive stock in Holdco until Year 3, at which point the Sub 1 and Sub 2 claimants received the common stock of Holdco's successor, Successor. Prior to Year 3, Sub 1 and Sub 2 established unpaid loss reserves for the amount of the Deficiency and Latent Deficiency Claims.

In Year 3, the Superior Court of State A approved the final valuation and proposed distribution of shares of Successor stock to Sub 1 and Sub 2 claimants pursuant to the Agreement. The court found that the value of the Latent Deficiency Claims against the Sub 1 Trust was \$a. The court found that this was a valid indebtedness from contracts entered into by Sub 1. The court further determined that the distribution of shares of Successor stock to holders of Deficiency and Latent Deficiency Claims was in full satisfaction of the valid indebtedness from contracts of Sub 1. The Court found that the value of the Latent Deficiency Claims against the Sub 2 Trust was \$b in the aggregate, and that interest was owed to claimants in the amount of \$c. The court ordered the distribution of Successor stock to holders of such claims, and declared such distribution to be in full satisfaction of the indebtedness from both contracts and general creditor claims of Sub 2.

In Year 3, the price of Successor stock ranged from approximately \$d to \$e per share. Therefore, the value of the stock distributed to Sub 1 claimants was approximately \$f and the value of the stock distributed to Sub 2 claimants was approximately \$g.

The amount owed on the Deficiency and Latent Deficiency Claims determined by the Superior Court of State A for Sub 1 and Sub 2, satisfied with the stock of Successor, was significantly greater than the value of the stock distributed in settlement of the claims. The amount owed for "interest" determined by the Superior Court of State A was likewise significantly greater than the fair market value of the stock distributed in settlement of the claims. Furthermore, the value of the stock distributed was significantly less than the established unpaid losses reported and determined by Sub 1 and Sub 2 prior to Year 3.

#### IV. Analysis

##### Law

Generally, if a debt is satisfied for less than face value, the debtor must include the difference in gross income as cancellation of indebtedness ("COD") income. § 61(a)(12). Exceptions to the general rule exist if the discharge occurs in a title 11 case or the debtor taxpayer is insolvent. § 108(a)(1). The taxpayer must reduce tax

attributes under § 108(b) to the extent COD income is excluded under § 108(a). In addition, if any taxpayer, regardless of whether it is bankrupt or insolvent, satisfies an indebtedness by issuing stock, the amount of COD income will be determined pursuant to § 108(e).

Prior to 1993, under § 108(e)(10)(A), if a debtor corporation transferred stock to a creditor in satisfaction of its indebtedness, the corporation would be treated as satisfying the indebtedness with an amount of money equal to the fair market value of the stock. Any excess of the amount of the indebtedness over the fair market value of the stock would be considered COD income. Under § 108(e)(10)(B), however, the excess would not be considered COD income if the debtor was in a title 11 case or an insolvent debtor to the extent of its insolvency. Therefore, if § 108(e)(10)(B) applied, a debtor would not recognize COD income regardless of the fair market value of the stock transferred in satisfaction of the indebtedness and would not be required to reduce any tax attributes under § 108(b).

Congress repealed § 108(e)(10) in 1993, effective for stock transferred after December 31, 1994. Congress also excepted transfers of stock in satisfaction of any indebtedness if the transfer occurred in a title 11 or similar case, as defined in § 368(a)(3)(A), that was filed on or before December 31, 1993.

Section 368(a)(3)(A) defines title 11 or similar case as a case under title 11 of the United States Code or a receivership, foreclosure, or similar proceeding in a Federal or State court.

Section 108(e)(8) now governs all stock-for-debt exchanges occurring after December 31, 1994, and not pursuant to a title 11 or similar case filed on or before December 31, 1993. Under § 108(e)(8), if a debtor corporation transfers stock in satisfaction of indebtedness, it will be treated as satisfying the indebtedness with an amount of money equal to the fair market value of the stock transferred. Any excess will be included in gross income as COD income.

Section 832(b)(5)(A) defines the term “losses incurred” as losses incurred during the taxable year on insurance contracts, computed as losses paid during the year, reduced by salvage and reinsurance recovered. This amount is then increased by the amount of discounted unpaid losses as of the end of the year, and decreased by the discounted unpaid losses as of the end of the previous taxable year.

Section 1.832-4(b) of the Income Tax Regulations provides that the part of the deduction for “losses incurred,” which represents unpaid losses at the close of the taxable year, comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company’s experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay. In the year the losses are paid, the deduction for losses incurred is reduced by the reduction in the unpaid loss reserve, while a deduction is allowed for the paid losses.

Section 163 provides that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

### Analysis

#### Issue 1

Information received since July 16, 2012 indicates Sub 1 and Sub 2 were considered discharged from indebtedness in Year 2. Thus, § 108(e)(10), rather than I.R.C. § 108(e)(8), applies to the stock-for-debt exchange.

Because Sub 1 and Sub 2 were not in a title 11 case, thus they must rely on I.R.C. § 108(e)(10)(B)(i)(II) to exclude from income any cancellation of indebtedness income. The facts indicate that in Year 2 when Sub 1 and Sub issued common stock to the trustees on behalf of the claimants, they were both insolvent. Accordingly, Successor does not have to recognize cancellation of indebtedness income under § 108(e)(10) to the extent Sub 1 and Sub 2 were insolvent on the date of discharge of indebtedness, even though the fair market value of the stock exchanged was less than the face amount of the debt.

#### Issues 2 and 3

In Year 3 the Superior Court of State A approved the final valuation and proposed distribution of shares of Successor stock to Sub 1 and Sub 2 claimants pursuant to the Agreement. The court declared such distribution to be in full satisfaction of the indebtedness from both contracts and general creditor claims of Sub 2.

Importantly, the total value of the Deficiency and Latent Deficiency Claims determined by the Superior Court of State A for Sub 1 and Sub 2, satisfied with the stock of Successor, was significantly greater than the fair market value of the stock distributed in settlement of the claims. Additionally, the fair market value of the stock distributed was significantly less than the established unpaid losses reported and determined by Sub 1 and Sub 2 prior to Year 3.

With respect to unpaid losses, Successor is not entitled to a deduction for Year 3 for additional unpaid losses with respect to the Latent Deficiency Claims because those claims were not outstanding at the end of the year. Moreover, in light of the of the company's expectation that it would satisfy these claims with stock worth substantially less than the court determination, that determination does not appear to represent a fair and reasonable estimate of the amount Successor would actually pay.

With respect to losses paid, Successor argues that the amount should be determined by reference to the court's order setting the total value of the Deficiency and Latent Deficiency Claims. We disagree. In our view, for purposes of determining losses incurred under § 832(b)(5) the amount, or value, of losses paid is the fair market value

of the stock because that amount represents the economic value expended to satisfy those claims.

Accordingly, we agree with your conclusion that the additional amount of loss that was determined in Year 3 to be theoretically owed, but never payable, is neither an unpaid loss nor a paid loss as of the end of the Year 3.

Under § 832(b)(5), when a claim - a loss – is paid, unpaid losses are reduced by the amount of the unpaid loss allocable to that claim. To the extent the amount of the unpaid loss allocable to the claim exceeds the loss paid, the excess reduces losses incurred for that year (i.e., is an item of income). A taxpayer which computes taxable income under § 832 will generally recognize income to the extent the amount of unpaid losses outstanding at the end of the preceding year exceed the sum of losses paid during the year plus unpaid losses outstanding at the end of the year. Section 832(b)(3). See also § 111(a); Allstate Ins. Co. v. United States, 936 F.2d 1271, 1272 (Fed. Cir. 1991). Thus, under § 832 Successor would recognize income (through a reduction of its otherwise recognized losses incurred deduction) to the extent the ultimate value of its paid losses is less than its unpaid loss reserves for the Deficiency and Latent Deficiency Claims in Year 3.

#### Issue 4

A taxpayer which computes taxable income under § 832 will generally recognize income (through a reduction of its otherwise recognized losses incurred deduction) to the extent the amount of unpaid losses outstanding at the end of the preceding year exceed the sum of losses paid during the year plus unpaid losses outstanding at the end of the year. In this case, however, Successor does not have to recognize the reduction of unpaid losses in Year 3 because of the operation of § 108(e)(10), if Sub 1 and Sub 2 were insolvent on the date of discharge of indebtedness, which date fell prior to the change in law in 1993.

#### Issue 5

The amount owed on the claims determined by the Superior Court of State A for Sub 1 and Sub 2, satisfied with the stock of Successor, was significantly greater than the fair market value of the stock distributed in settlement of the claims. Furthermore, the amount owed for “interest” determined by the Superior Court of State A was likewise significantly greater than the value of the stock distributed in settlement of the claims. This “interest” amount was never payable, nor ever paid by Successor. Because Successor transferred stock with a fair market value significantly below the dollar amount of the claims satisfied, no amount determined as “interest” by the court, even if it were interest on indebtedness for Federal tax purposes, would ever be payable or paid. Accordingly, Successor is not entitled to a deduction for “interest” assigned to the claims because the value of the stock used to pay such claims (in the stock for debt exchange) was insufficient to “pay” an “interest” amount.

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